No. 12973

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

SHAFFER TERMINALS, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Reply Brief

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Respondent's argument appears to be;

(1) That rentals paid by Petitioner to the partnership were not deductible as ordinary and necessary expenses under Section 23(a)(1)(A) of the Internal Revenue Code because the transactions between the Petitioner and the partnership were not "in substance what they appear to be in form";

(2) That the transactions between Petitioner and the partnership were sham and unreal, and so to be disregarded for tax purposes because they did not serve "any real business purpose for the taxpayer", (Respondent's Brief p. 12); and because they were entered into as a tax avoidance device. (Resp. Brief pp. 8 and 21).

REPLY TO RESPONDENT'S ARGUMENT

The use of Clark fork type Lift Trucks was essential to the Petitioner's business. The rental paid for the use of such equipment is clearly a deductible expense under I. C. R., Sec. 23(a)(1)(A) and Section 29.33(a)-1 of Treasury Regulations No. 111. The rental paid by Petitioner to the United States Army and others, both before and after the organization of the partnership, was without question allowed as a deductible expense. The amounts of rental so paid and the dates of payments were as follows: (R. 33 & 34)

	Paid to	
Dates of Payment	U.S. Army	All Others
1942	$ 1,726.50	$ 3,377.00
1943, Jan. to Sept., incl.	20,047.50	10,548.75
1943, Oct. to Dec., incl.	5,646.00	267.00
1944	32,603.25	Nil
1945	15,288.75	Nil

The threat of recapture by the Army of its equipment and the increased demand made on Petitioner by Governmental agencies in the furtherance of the war effort created the paramount necessity that Petitioner obtain the use of additional equipment of that type. Securing the use of additional equipment, therefore, served a business purpose of petitioner.

Had Petitioner been able to obtain such use by renting such equipment from the United States Army or from others than the partnership, the deductibility of the rental paid would be unquestionable. The rental thereof from the partnership involved no change in the Petitioner's method of doing business, and the rent paid therefor was as much an ordinary and necessary expense as the rent paid to others for like equipment.

The case, therefore, turns upon the question whether the transactions between Petitioner and the partnership were "recognizable for tax purposes."

The Tax Court's conclusion that they were not (R. 189) is characterized in Respondent's brief, at page 12, as "this ultimate factual conclusion."[1] On the contrary, it is a conclusion of law upon the decisive issue in the case, and, we repeat, clearly erroneous. That conclusion

[1]This characterization is based upon *Limericks, Inc. v. Commissioner*, 165 Fed. (2d) 483 (CCA 5th), which was decided January 23, 1948, before the rule in the Dobson case *(Dobson v. Commissioner*, 320 U.S. 489, 88 L. Ed. 248) was abrogated by the Act of June 25, 1948, c. 646, Sec. 36; 62 Stat. 991. See *Grace Bros. v. Commissioner*, 173 Fed. (2d) 170, at 173 (CCA 9th).

and the argument made in Respondent's brief in support of it are based upon *ex post facto* considerations and disregard controlling factors and principles.

As stated in Petitioner's Opening Brief, at page 7, early in 1943 Petitioner was "confronted by the paramount necessity of obtaining additional equipment." No such equipment was available for rental in the Puget Sound area. New equipment could not be acquired (i. e., purchased) except on priority, which the taxpayer could and did obtain because of its essential war activities. (See Respondent's brief, page 4.)

In the belief that Petitioner could not finance the purchase of such equipment or, at any rate, that it was not good or sound business for it to attempt to do so, and in the exercise of their "legal right to conduct their business affairs through a medium of their own choice" (*Twin Oaks Co. v. Commissioner,* 183 Fed. (2d) 385, at page 387), the stockholders of Petitioner organized the partnership, Equipment Associates, to finance the purchase of this equipment and paid in its initial capital of $10,000.00 in "cash furnished equally by the partners." Petitioner, as the holder of the required priority, ordered the equipment, and to avoid entanglement in Governmental red tape which might result if it appeared that the supplier of the equipment was paid by someone other than the holder of the priority (actually at the

suggestion of the supplier, though not so shown by the record) Petitioner sent its check in payment of each delivery, but as to the first and second deliveries, at least, its funds were in no way depleted thereby since it received payment from the PARTNERSHIP ~~Petitioner~~ before its checks were presented for payment. There is nothing in the record to impugn the honesty of the judgment of the officers and stockholders of Petitioner that in the circumstances existing in August and September, 1943, when the Petitioner had a cash balance on August 31, 1943 of $115.72 only, when the continuance of trans-Pacific lend-lease shipments to Russia was subject to interruption at any time by the Japanese, and when even the outcome of the war with Japan hung in the balance, Petitioner's financial condition and prospects did not justify its borrowing money to purchase such equipment even though such a loan could have been obtained, which they had every reason to believe could not be done.

Respondent labors at length to prove that in the events which happened subsequent to that crucial time in 1943 when the partnership was organized, Petitioner could have financed the purchase of the equipment. From that much-labored foundation of hindsight, it is argued that the transactions were sham and unreal. However, they would have been very real to the partners had the Japanese gained mastery of the Pacific, which possibility was very gravely present in September

1943. In that event, the partnership would have been left with the equipment on its hands but without use therefor and neither income nor much chance of salvage therefrom.

In the course of this labored argument, it is asserted:

> "The arrangement here did not achieve the business result claimed for it, namely, to increase the taxpayers' working capital, since the 'capital' retained transitorily was immediately disbursed in the form of 'rentals' and removed from the possibility of use in the business." (Respondent's brief, p. 21.)

The utter fallaciousness of this statement is self evident. What the transactions between Petitioner and the partnership did was to provide the Petitioner with the use of essential equipment without the investment of a dollar of its capital. On the other hand, the utter unsoundness, from a business and financial standpoint, of the investment by the Petitioner of borrowed capital in equipment is easily demonstrated. From September 1943 through December 1945, Petitioner paid the Partnership as equipment rental a total of $77,454.78. During that period it was in the 90% tax bracket. If it had purchased the equipment and not paid the rentals, its income would have been increased by the amount of such rentals with the result that its taxes would have been increased $69,712.00 and it would have been left with but $7,742.78

to apply on the cost of the equipment or the loans made for the purchase thereof.

Much emphasis is put upon the fact that beginning in 1943, Petitioner's business increased very rapidly (see Resp. Brief 4, 10 and 13) as though that fact demonstrates that Petitioner could have financed the purchase of the additional equipment. Actually, it, with other facts both in the record and of which this Court will take judicial knowledge, proves the contrary. The increase in business inevitably brought increased expenses—for labor, for rental not only of equipment but of terminal facilities, and other current operating expenses—and consequent increased demands upon Petitioner's cash working capital. These latter demands were met, and could only be met, by increased borrowings, which increased from $15,000.00 on August 31, 1943 to $52,000 on December 31, 1944 (R. 37). Moreover, Petitioner's earned surplus, to which reference is made in Respondent's brief, p. 7, declined in 1944 from $83,219.31 at the beginning of the year, to $67,303.28 at the end of that year. See Income and Excess Profits Tax Return for the year 1944 (R. 39-42). That loss was due to income and excess profits tax of $54,554.15 for the year 1943, which was paid in 1944 and for which no reserve was set up and which is not taken into account in the summary of Petitioner's working capital position, (Ex. 5, R. 37.) Taking that liability into account, Petitioner's

current assets at the end of 1943 exceeded its current liabilities by only 24,770.24. Such working capital position obviously did not warrant a capital loan for the purchase of capital assets.

At page 14 of Respondent's brief, it is asserted that the present case is indistinguishable from *Armston v. Commissioner,* 12 T.C. 539, affirmed, 188 Fed. (2d) 531 (CCA 5th). With proper deference to the author of that brief, we submit that such assertion is wholly unwarranted. In the Armston case, the corporation taxpayer had for years owned its equipment. All of its stock was owned by H. W. Armston and his wife. One and three-sevenths shares were registered in the name of K. W. Kerr, but they were qualifying shares and they were beneficially owned by H. W. Armston (See 12 T.C., p. 541, and cf. Respondent's brief, p. 14). For no reason except to reduce its tax liability, the corporation sold its equipment to Mrs. Armston under an arrangement whereby she leased it back to the corporation at going rentals. "That transaction served no business purpose." .... "It was merely a device for minimizing tax liability." 188 Fed. (2d) at page 533. The corporation, with no compulsion, business or otherwise, changed its position from that of the owner of equipment required in its business to that of lessee thereof, but with no change in the flow of economic benefits. Armston and his wife continued to receive the profits of the corporation's business,

but in the form of rentals plus dividends and not merely dividends alone. There was "a mere paper reallocation of income among the family members," . . . . "the actualities of their relation to the income did not change." *Commissioner v. Culbertson,* 337 U.S. 733, at 746, 93 L. Ed. 1659, at 1667, quoting *Commissioner v. Tower,* 327 U.S. 280, at 292.

Respondent places great reliance upon the finding of the Tax Court "that the partnership was organized 'primarily to *avoid* the excess profits tax and its impact on the earnings of petitioner.' " (See Respondent's brief, pp. 11 and 15.) He does not challenge the proposition that "a taxpayer has the right to decrease its tax liability by any lawful means."

The Court will take judicial notice that following the reimposition of the excess profits tax by the Excess Profits Tax Amendment of 1941 and the Revenue Act of that year. many corporations converted to partnerships, and with the repeal of that tax reconverted to corporations. Such conversions were in the exercise of a legal right and were not disregarded for tax purposes as sham and unreal because they avoided the excess profits tax liability.

It is to be noted that so far as this is a finding at all. it is a finding as to purpose and motive and a finding of a lawful purpose. Moreover, being a finding as to pur-

pose or motive only, it is wholly immaterial. "Motive to avoid taxation is never relevant." *National Investors Corporation v. Hoey,* 144 Fed. (2d) 466, at 488. See also *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436, 87 L. Ed. 1499.

Respondent does not dispute or in any way challenge the fact that the purpose of the organization of the partnership, Equipment Associates, was both the equivalent of business activity and was followed by the carrying on of business, and on the strength of that principle alone, the transactions between the Petitioner and the partnership cannot be disregarded in determining the incidence of taxation.

Respondent's only answer to the proposition that these transactions cannot be disregarded as sham and unreal because they changed the flow of economic benefits, is to be found on page 22 of Respondent's brief. The contention there made was repudiated by this Court in *Twin Oaks Co. v. Commissioner,* 183 Fed. (2d) 385. See Opinion p. 387.

In the last analysis, Respondent's position seems to be that while it may be true that taxpayers have the legal right "to conduct their business affairs through a medium of their own choice" and the right to avoid tax liability by any lawful means, yet the Government has the right,

by bureaucratic finding, to say that transactions between a corporation and its stockholders are a sham and unreal if they result in a reduction of tax liability, because the Government has the right to say that a corporation and its stockholders must conduct their business only in the way which will produce the greatest amount of taxes.

As was well stated by the Circuit Court of Appeals for the Fifth Circuit, in *Ross v. Commissioner,* 129 Fed. (2d) 310, at 313:

> "In tax matters it is only under exceptional circumstances that the separateness of the corporation from the stockholders can be disregarded, even when there is but one stockholder. *Burnet, Commissioner v. Clark,* 287 U.S. 410, 53 S. Ct. 207, 77 L. Ed. 397; *Burnet, Commissioner v. Commonwealth Improvement Co.,* 287 U.S. 415, 53 S. Ct. 198, 77 L. Ed. 399."

It is submitted that the exceptional circumstances that would warrant the disregard of the transactions between the Petitioner and the partnership are not present in this case.

WHEREFORE, Petitioner renews the prayer of its opening brief.

Respectfully submitted,

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